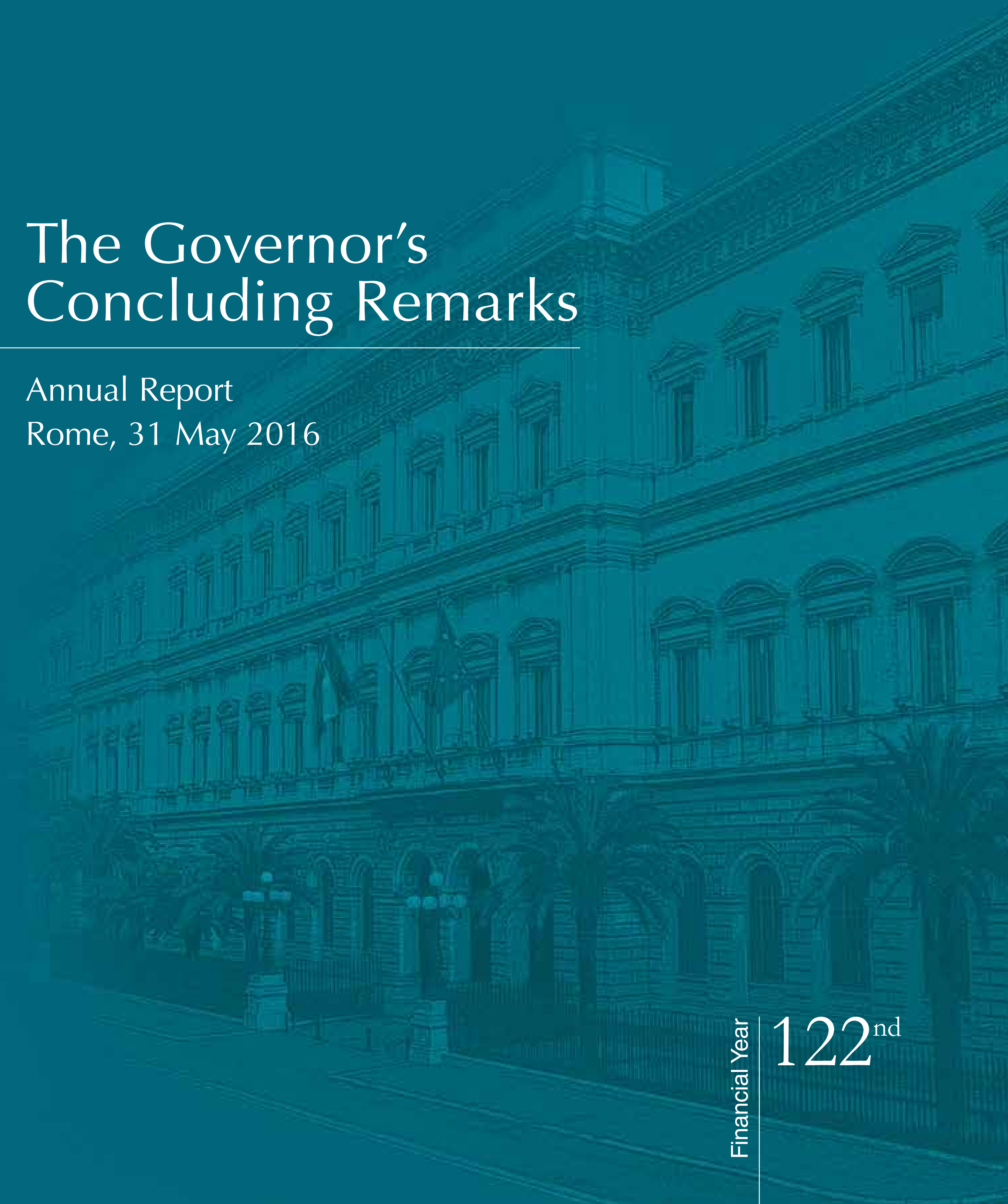
BANCA D'ITALIA
EUROSISTEMA

The Governor's Concluding Remarks

Annual Report
Rome, 31 May 2016

122nd FINANCIAL YEAR

2015



Financial Year 122nd

BANCA D'ITALIA
EUROSISTEMA

The Governor's Concluding Remarks

Annual Report
2015 - 122nd Financial Year

Rome, 31 May 2016

Ladies and Gentlemen,

This year for the first time the presentation of these concluding remarks does not coincide with the Ordinary Meeting of Shareholders called to examine and approve the Bank's annual accounts. That meeting, as you may recall, was held on 28 April, and starting next year it will be held by the end of March, as provided for in our new Statute. This is in line with the need that has arisen within the Eurosystem to approve and publish the annual accounts of the euro-area central banks according to a common deadline.

Our financial results for the year, then, are already known; let me briefly summarize them. The monetary policy operations conducted in response to the crisis led to unprecedented growth and recomposition of the assets of the national central banks, with the Bank of Italy posting an increase of €57 billion in 2015; the gross profit for the year amounted to approximately €6 billion, practically unchanged from 2014. Given the increased size of the balance sheet and the risks associated with the progressive implementation of the asset purchase programmes undertaken in furtherance of monetary policy aims, the provision for general risks was increased by €2.2 billion. The Bank of Italy's net profit of €2.8 billion was allocated as follows: €300 million to the ordinary reserve and a dividend of €340 million to shareholders, the same as last year; the amount allocated to the State was €2.2 billion, in addition to €1 billion in taxes.

The transition period that Parliament allowed for shareholders to dispose of their holdings in the Bank's capital in excess of the 3 per cent ceiling expires at the end of this year. As of April, almost 14 per cent of the capital had been transferred to 50 new shareholders. A plan has also been drawn up to make the secondary market for the shares liquid.

In its internal management, the Bank has pursued the strategic objectives of consolidating and further strengthening its role within the Eurosystem, improving its services to the public and making more efficient use of resources. This year I will present the Report on Operations and Activities that the Bank is required by law to make to Parliament. Here this morning I will touch on the major events.

In 2015 we launched a new plan for the rationalization of the branch network to improve service quality and achieve permanent cost savings. With the closure of 19 branches and 3 detached supervision divisions, chosen on the basis of local demand for the services of each, the network now consists of 39 branches; there were 97 in 2008. With the definitive abandonment of the old provincial branch structure, the branches located in the regional capitals play a central role in the Bank's new configuration.

The larger branches will now take on greater responsibilities in supervising financial intermediaries, safeguarding the interests of bank customers, performing monetary policy operations, and handling the circulation of banknotes and coins. To meet growing public demand, four new Banking and Financial Ombudsman panels will be established by the end of this year in Bari, Bologna, Palermo and Turin, joining those already in operation in Milan, Naples and Rome.

After lengthy talks with the trade unions, we have made highly innovative changes to our personnel regulations. The reform reduces the number of hierarchical levels, fosters the organization of work by objectives, and envisages pre-determined terms of office for executives, review of managers' performance by peers and colleagues, and a strong emphasis on the diversity of skills and professional profiles among our staff. The new organization aims to promote the constant development of our human capital, favour demographic turnover, encourage staff to take on responsibilities, and streamline decision-making processes.

In order to create a working environment that guarantees respect, inclusion and well-being for all, the Bank made nurturing diversity one of the objectives of its strategic plan for the three-year period now nearing an end. In keeping with this philosophy, the Bank stands ready to apply in full the principles laid down in the new law introducing and regulating civil unions and strengthening the provisions concerning cohabitation.

The European Single Supervisory Mechanism has been in effect since November 2014. The staff of the European Central Bank and those of the national supervisory authorities cooperate closely; the joint supervisory teams responsible for the supervision of the most important banks operate in a setting that exploits the diversity of experience. We are committed, along with the other system authorities, to guaranteeing the complete development of common supervisory practices.

After the Bank of Italy's designation as the national resolution authority for banking crises under the new Single Resolution Mechanism, we instituted a Resolution and Crisis Management Unit which reports directly to the Governing Board. The Unit intervenes in crisis management, works with the Single Resolution Board, and oversees the liquidation of banks and financial intermediaries.

The Bank of Italy endeavours to prevent money laundering and terrorist financing in Italy, working directly with its Directorate General of Financial Supervision and Regulation and through the Financial Intelligence Unit (FIU). The system assessment recently conducted by the Financial Action Task Force (FATF) acknowledged its efficacy and full compliance with global standards; its competencies and autonomy make the FIU an essential support in investigations and legal proceedings. Targeted regulatory intervention in accordance with the new European rules and with FATF recommendations could be achieved with the transposition of the Fourth EU Anti-Money-Laundering Directive. In 2015 the number of suspicious transaction reports continued to increase rapidly; cooperation with other Italian and foreign authorities has deepened, a particularly important factor in the fight against terrorist financing.

The TARGET2-Securities platform for the settlement of securities transactions in central bank money, which the Bank of Italy manages jointly with Deutsche Bundesbank, began operations last June. The launch of this complex infrastructure, developed with the central banks of France and Spain, was a success; the Italian financial system migrated to the new platform on 31 August. By the end of 2017 the TARGET2-Securities platform will be settling securities transactions in 21 countries. This marks an important step towards the full integration of European financial markets. With the completion of this project, we have further consolidated the Bank's long-established role as provider of high-tech services to the Eurosystem, such as the TARGET2 system for the gross settlement of euro-area payments.

We have increased our media presence. The serious episodes involving some Italian banks have spurred us to redouble our efforts to explain, in rigorous technical terms and in the clearest possible way, our supervisory action and the positions taken, in accord with the Government, in discussions with European institutions. The main channel used to publish documents, notes of clarification and interventions is our website. We have reported to Parliament at special fact-finding hearings. We are aware of the importance of timely and effective communication and we are striving to improve its quality, while complying with the confidentiality constraints imposed on us by national law and European rules to safeguard the efficacy of preventive supervisory action and any judicial inquiries.

In a year that was once again challenging, all the women and men who work at the Bank of Italy have continued to demonstrate the highest degree of professionalism and a strong sense of responsibility. It is no mere formality that I express, personally and on behalf of the Governing Board, a profound appreciation of their dedication.

The monetary policy response to the risks of deflation

Notwithstanding signs of strengthening in the first quarter of this year, the euro-area economy remains exposed to global risks. Trade continues to soften, and uncertainty persists regarding the ability of China and other emerging countries to avoid a sharp slowdown of their economies. In the euro area, domestic demand needs to consolidate further in order to counter the slackness of foreign demand.

Concerns about the prospects for the European banking system continue to afflict the markets, heightened by uncertainty concerning the macroeconomic outlook, the regulatory stance, and the as yet incomplete configuration of banking union. In some countries, the problems of the economy and public finance are interwoven with those of political instability; in many, hostility to the European project is gaining traction. A negative outcome of the referendum on the United Kingdom remaining in the European Union could engender profound instability.

For monetary policy, the main challenge remains the persistence of excessively low inflation, which turned negative in the first few months of this year. This phenomenon is not limited to the euro area. In large part it stems from the fall in oil prices, but it also depends, to a significant extent, on internal dynamics: the margins of unused plant capacity and available labour are wider than in other advanced economies.

As I have recalled on several occasions in recent years, like excessively high inflation, an overly subdued price dynamic is also harmful for economic and financial stability, especially when public and private debt are high and growth is weak. Resolute action is being taken to dispel the risk of a prolonged detachment of inflation expectations from the level consistent with the central bank's objective. In the euro area, the responsiveness of longer-term expectations to the fall in short-term expectations, which is very modest under normal circumstances, remains pronounced, albeit less so than between the end of 2014 and the start of last year.

We have acted with determination to encourage the return to price stability; as reiterated by the Governing Council of the ECB at its last monetary policy meeting, in furtherance of this objective we will continue if necessary to deploy all the instruments made available to us in our mandate. Official interest rates have been reduced repeatedly, bringing the Eurosystem's deposit facility rate to negative levels. At the start of 2015 the Governing Council extended its Asset Purchase Programme to include public sector securities; in December the duration of the programme was prolonged to at least the end of the first quarter of 2017; in March we decided to increase the amount of monthly purchases and to begin, as of June, purchasing investment-grade bonds issued by non-bank corporations. We also introduced new longer-term refinancing operations with conditions rewarding banks that provide more credit to the economy.

These measures are of an exceptional scale. The financial asset purchases reached 9.4 per cent of euro-area GDP on 20 May and will reach 17 per cent in March 2017. In the other main advanced countries, the programmes adopted by the central banks have attained even larger dimensions: approximately 20 per cent of GDP in the US and the UK and upwards of 60 per cent in Japan.

The evidence demonstrates the efficacy of the expansionary measures. The cost of credit to the economy has fallen and financial fragmentation in the euro area has lessened. The measures have fostered a decline in yields and bolstered the prices of a wide range of financial assets, with a positive impact on consumption, through wealth effects, and on investment, through the fall in the cost of capital. They have buoyed business and household confidence. According to our estimates, without the monetary policy measures introduced between the middle of 2014 and the end of 2015, annual inflation and GDP growth would be about half a percentage point lower in the euro area in the three years 2015-17. For Italy, the estimated effects are more pronounced.

The highly expansionary monetary policy stance is the result of well thought out decisions and reflects the weakness of the economy and the risk of deflation. The concerns voiced by some observers that a long period of very low interest rates could have a destabilizing effect on financial markets, adverse repercussions on the profits of banks and other intermediaries, or undesired distributive consequences must be carefully considered; however, they must not be overstated.

At present, in the euro area as a whole there is no evidence of an excessive increase in the prices of shares, corporate bonds or houses. The growth in lending in relation to the cyclical position of the economy is moderate. Risks that may possibly arise in specific sectors can be addressed with selective macroprudential instruments, as has already happened in some countries, without interfering with the stance of monetary policy.

Very low or negative interest rates can dent the profitability of banks and institutional investors. For pension funds and insurance companies, the risks derive from maturity and yield mismatches between assets and liabilities which may require greater diversification of portfolios, stronger capital buffers, and changes to contractual conditions. For banks, the lowering of rates squeezes interest margins but, besides producing capital gains on their securities portfolios in the short term, it has a positive effect on loan demand and the quality of credit. The impact differs according to the individual bank's characteristics; the information available for euro-area banks indicates that the overall effects on profits have so far been limited.

In the current cyclical conditions the main risks to financial stability, to the profitability of banks and firms, and even to household income continue to come from the uncertain macroeconomic outlook and the persistence of exceptionally low inflation. Strengthening the economy is key to increasing medium- and long-term yields and to mitigating the risks to financial stability.

All economic policies must contribute to this objective. Monetary policy must be accompanied by fiscal policies that are consistent with cyclical conditions and with each country's debt position, and by reform measures designed to permanently increase growth potential and job creation.

The Italian economy: recovery and vulnerability

Last year, the Italian economy returned to growth for the first time since the onset of the sovereign debt crisis. The positive signs are unmistakable, especially for domestic demand. However, economic activity is still far below its pre-recession levels and is subject to the same uncertainties weighing on the global and the European economy.

The recovery, initially concentrated in the manufacturing sector, later spread to services and, somewhat hesitantly, to construction. The improvement in the labour market and the Government's income support measures have been favourably reflected in consumption.

Following a prolonged contraction, capital formation has gradually picked up again. Our surveys point to a further expansion in firms' investment plans in manufacturing and services. The expansion now also involves industrial firms mainly producing for the domestic market. Contributory factors have included the improvement in borrowing conditions and the temporary fiscal incentives in force since the end of 2015. According to our estimates, the incentives could increase investment by 2.5 percentage points overall in 2016-17.

The decline in lending to firms has virtually halted. Banks are actively seeking to use the abundant liquidity at their disposal, above all by lending to firms in a stronger financial position and operating in the manufacturing sector. The cost of credit has come down appreciably for both large and small firms.

In relation to GDP, however, investment is still far below its pre-crisis levels, at historical lows. Looking ahead, the main cause of uncertainty is the outlook for foreign demand: firms see heightened geopolitical risks, which affect economic activity adversely both through their direct impact on exports and through the greater caution in investment plans that they induce.

As has been observed repeatedly and in many quarters, a relaunch of investment in construction, principally to renovate existing buildings, enhance public facilities and mitigate hydro-geological risks, would have major effects on employment and economic activity. A substantial amount of Italian territory is in fact urban, but there are a great many buildings and infrastructures in a state of disrepair, while little progress has been made to date on environmental protection and energy efficiency. The modernization of our urban heritage also requires legislative initiatives to forge a more effective linkage between national and local norms and to create more favourable conditions for private investment. Achieving this requires a broad consensus, on a par with that required for the conservation and enhancement of Italy's extraordinary natural and artistic heritage.

The signs of economic improvement have now begun to spread to the South and Islands, although the gaps with respect to the rest of Italy have continued to widen. Preliminary estimates indicate that after seven consecutive years of recession, output in this part of the country has stopped contracting. In areas lagging behind it is vital to exploit all the opportunities for investment financing offered by the European Union. Fund utilization was higher last year than in the past, thanks above all to the reallocation of resources from projects behind schedule to those already under way. The impact of this financing on economic growth could be amplified by improving the planning stage and by project selection on the part of central and local authorities that favours direct investment over subsidies to firms, whose lack of efficacy we have repeatedly documented.

The demand for labour has begun to grow again, at a higher rate than was expected a year ago and involving areas, sectors and occupational categories passed over by the signs of improvement of 2014. The new rules governing employment relationships have had a positive effect and, as of today, social security contribution relief even more so. The rise in employment has now extended to permanent hirings; it includes the South and Islands. After decreasing for three years, the number of hours worked has risen, albeit slightly, in industry too. Employment held firm in the early months of the year, even though many hirings had been brought forward to the end of 2015 in view of the reduction in social security relief from January onwards.

The youth unemployment rate has fallen for the first time since 2007, declining by more than 2 percentage points. Unemployment is still too high, however. Its progressive reduction, crucial to ensuring citizens have adequate living conditions, is also necessary for bringing inflation back in line with price stability. In Italy, as in other countries, the responsiveness of wages to changes in unemployment is high; it is estimated that reducing the unemployment rate by 1 percentage point would correspond to additional wage growth of nearly 1 point over the following three years.

Job gains could be greater if the recovery of domestic demand strengthens. Its increase has been greatly influenced by the strongly expansionary stance of monetary policy; fiscal policy has also contributed, although the room for manoeuvre is inevitably limited, given Italy's high public debt. Yet increasing the economy's capacity for growth is an essential objective. Both quantitatively and qualitatively, the potential growth rate is not set in stone, a replication of the disappointing performances of the past. Rather, it can be stimulated through appropriate measures; it depends on investment decisions and resource allocation mechanisms.

Despite the highly fragmented nature of the productive economy, which curtails its overall competitiveness, the positive performance of many firms on international markets shows that Italy has the potential to recoup the growth gap it has accumulated in the last twenty years. Our surveys show that a considerable number of firms use new technologies, even in the traditional sectors. Signs of vitality are visible throughout Italy, both in manufacturing, with highly innovative and technologically advanced processes, and in services. This has benefited exports; despite the weakening of world trade, they grew faster in 2015 than the potential demand from outlet markets, as they have done regularly since 2010. Italian exporters also succeeded in expanding their market position in mature markets; the gain in sales abroad was exceptionally positive for motor vehicles.

However, the high incidence of small firms in our productive economy is a continued source of weakness. Since the beginning of the 2000s, the exports of firms with fewer than 50 workers have failed to keep pace with those of larger firms. Not only do Italian companies start out smaller, on average, than those of the other main European countries, they also find it harder to expand.

Support should be given to innovative entrepreneurial initiatives, to business incubation, and to a quicker reallocation of productive resources to firms with better growth potential. In 2012 criteria were established for innovative start-ups to qualify for a broad range of benefits, including incentives for those investing in their equity and a fast track for obtaining guarantees on bank loans. Preliminary evidence indicates that the programme enabled these firms to get larger flows of financing and to sustain higher rates of investment.

The priorities for reform are clearly identified: first and foremost, they are to eliminate the obstacles to entrepreneurship posed by illegal activities, inefficiencies in general government and civil justice, shortcomings in the regulation of firms' market entry and exit, limits to competition, and insufficient resources and incentives for investment in innovation, research and human capital. The results obtained in labour market reform and the reduction of the backlog in civil justice, thanks mainly to the introduction in recent years of measures to reduce litigation, are two examples demonstrating that the reforms undertaken can be effective, even if their effects mostly unfold in the medium term.

The rule of law is the sine qua non for growth. Stepping up the fight against tax evasion, corruption and organized crime, giving continuity to the measures put in place in recent years and expediting their implementation, could make it possible to support the activity of the many competitive and law-abiding firms, guaranteeing that everyone follows the rules and that competition is not restricted or distorted.

The general government reform approved by Parliament last year is an important step. Its effects on economic activity and on people's lives will depend on the manner and timeframe of its implementation. The effort to simplify administrative activity and to revamp its organization requires renewed impetus. The initiatives designed to facilitate user identification and the payment of services via the Internet can further the digitization of Italy.

Last summer's changes to the legislation on the management of company crises and the additional measures recently approved will facilitate the recovery of firms whose difficulties are reversible and ease the exit from the market of those that are no longer profitable. To stimulate the entry of new firms it is important that the annual legislative bill on competition be speedily passed.

The increase of the ratio of debt to GDP, from just under 100 per cent in 2007 to almost 133 per cent last year, is largely a consequence of the crisis. If during that period real GDP growth had been in line with that of the previous decade and the deflator had evolved in keeping with the inflation target for the euro area, the debt burden would have risen by only 3 percentage points, slightly less than the increase stemming from Italy's financial assistance to countries in difficulty; had the positive effects of stronger growth on the government deficit been taken into account, the debt burden would have been lower. This simple exercise highlights the risk posed to the economy of a country whose competitiveness is lagging seriously behind and the importance of structural reforms to support its growth potential: they are all the more necessary when the public debt is so high.

Following the recession triggered by the global financial crisis, fiscal policy limited the deficit, curbing the growth of the debt-to-GDP ratio. The primary budget balance returned to surplus in 2011 and net borrowing was brought back below the threshold of 3 per cent of GDP in 2012. Keeping primary current expenditure in check played an important role: after recording modest growth in nominal terms up to 2014, it remained practically unchanged last year.

Since 2014, when a particularly difficult three-year period for the Italian economy ended, the fiscal policy has become moderately expansionary. The Government seeks to reconcile support for growth with the reduction of the debt-to-GDP ratio, which was appropriately indicated as a strategic objective. In the Government's plans, the reduction is to begin this year and gain pace in the next three. The way in which the macroeconomic context will evolve could hinder the achievement of this goal in 2016. Careful monitoring of the public finances and the implementation of a programme of privatizations could permit the debt-to-GDP ratio to approach the planned objective and ensure a significant reduction in 2017.

With a view to supporting a faster, more durable recovery, it is necessary to revamp long-deferred targeted public investment, including in intangible infrastructure; it is also important to further reduce the tax wedge on labour, bolster incentives to innovate and provide income support for the less well-off, hit especially hard by the crisis. While the budget affords limited leeway for these measures today, it is possible in any event to plan their implementation over a longer time horizon.

Building Europe: progress and uncertainties

The present conditions and prospects of the individual countries of the euro area are closely linked to those of the European construction. For years the area has withstood formidable tensions. The effects of the global financial crisis had not yet been absorbed when the sovereign debt crisis erupted. Triggered by weaknesses in individual countries, that crisis was fuelled by the incompleteness of the Economic and Monetary Union. Hesitancy in defining the procedures for support to countries in difficulty, due in part to the lack of adequate tools, fed fears of a break-up of the area. The spreads on government bond yields widened dramatically, in some cases much more than was justified by the economic conditions and public finances of the countries affected.

Measures to deal with the emergency have been progressively flanked by reform of the governance of the European Union and especially the euro area, initiated by intervention on public finance rules and macroeconomic surveillance. In the summer of 2012 the President of the European Council published the report 'Towards a Genuine Economic and Monetary Union', prepared with the Presidents of the Commission, the Eurogroup and the European Central Bank. The report proposed taking, over a decade, concrete steps towards banking and fiscal union and strengthening the democratic legitimation of the common institutions, the embryo of political union. The Governing Council of the ECB reiterated its determination to defend the single currency: the announcement of the possibility of purchasing government bonds on the secondary market was immediately reflected in a drastic narrowing of yield spreads.

The reform process outlined in the report envisaged a gradual renunciation of national sovereignty in economic and financial matters and the flanking or replacement of national intervention tools by corresponding common instruments. For banks, the report proposed transferring supervisory responsibility to the euro area and establishing joint crisis resolution and deposit guarantee mechanisms, to be supported with public funds through the European Stability Mechanism (ESM). As to public finance, in addition to implementing the reforms already approved (the Six Pack and the Fiscal Compact), it proposed gradual steps towards the creation of a euro-area budget and the issue of common debt. Most of these proposals were taken up again in subsequent reports, somewhat less ambitious on certain themes, including the Five Presidents' Report of June 2015.

The results have been significant but uneven. The restrictions on the use of national mechanisms were put in place quickly, but the introduction and sharing of their supranational counterparts has been delayed. Likewise, a contained risk-sharing approach was adopted for common intervention to help individual member states in difficulty. The establishment of the ESM has superseded the restrictive tenor of the no-bail-out clause in the European Treaty that would have precluded any form of assistance; however, the financial capacity of the fund is modest as it is supported by limited guarantees of the member states.

The new institutional structure and many of the decisions that flowed from it were directed primarily at reducing the risks proper to individual member states or banks, even aside from the possible systemic implications.

This, in short, creates a situation of vulnerability: there is the danger not only that national and European authorities will be unable to react adequately to major shocks, but even that they will have trouble avoiding contagion triggered by circumscribed tensions. To effectively reduce overall risk, the measures designed to attenuate specific fragilities must be accompanied by adequate safety nets based on supranational instruments.

In the case of the banking system, the possibility of utilizing public resources, whether national or European, as a means of crisis prevention and management has been virtually eliminated. International experience demonstrates that, in the face of a market failure, prompt public intervention can prevent the destruction of wealth without necessarily generating losses for the State, and indeed often producing profits. Greater scope for intervention of this sort, exceptional as it may be, should be reinstated.

Moreover, the European Commission's position on state aid precludes the use of mandatory deposit insurance schemes for purposes of crisis prevention and orderly crisis resolution, even though these funds are private, given that they are financed and independently managed by banks; the effective conduct of recovery and resolution procedures, instead, requires the use of all the tools available. There is no reason to stigmatize as improper state aid those initiatives that help to correct market failures without undermining competition. A rigid interpretation of the regulations on state aid, with little regard for financial stability, has also hindered the plan for creating a company to manage Italian banks' non-performing loans.

With burden sharing and bail-in, it was decided to protect taxpayers by imposing instead a direct cost on savers and investors. The new regulations are a response to events in banking systems other than the Italian one that were directly hit by the global financial crisis and rescued by massive state aid. The new regulations were rightly designed to combat opportunistic behaviour by banks, but their application must balance this objective against that of stability. Contrary to what was proposed by the Italian delegation in official fora, an adequate transitional period was not provided to give all the parties involved time to acquire a full understanding of the new regime, nor has the application of the new system to debt instruments already marketed, even to retail investors, been ruled out.

Banking union must ultimately incorporate all the elements envisaged in the original design. The Single Resolution Fund has been created but the resources contributed by the banks, initially subdivided by country, will not be pooled for some time; and no clear determination to use it has transpired. The single deposit guarantee system has not yet been finalized; the European Commission recently presented a proposal, it too envisaging a lengthy period of transition. In both cases there is no provision for a European public financial backstop, which has been called for since the 2012 Report and is necessary to guarantee that banking union has the capacity to safeguard systemic stability.

In discussion and in the political debate, the theme of prudential requirements against sovereign exposures is often linked with that of the completion of banking union, on the grounds that risks have to be reduced before they can be shared. The issue needs to be addressed with no preconceived opinions, and without taking hasty decisions that could aggravate rather than mitigate risks. There is no consensus on the overall advantages of the various reform options: furthermore, experience teaches that transitions originally intended as gradual are often suddenly speeded up by the market. In any case, the issue needs to be resolved in a coordinated way at global level and in the proper institutional fora.

Poor compliance with fiscal rules in the period preceding the crisis justified their being strengthened, but these last few years have demonstrated how important it is to enforce them taking account, as foreseen by the rules, of exceptional circumstances and the concurrent implementation of longer-term intervention. At the beginning of last year the European Commission established the conditions for applying the flexibility clauses of the Stability and Growth Pact, which can allow national budgets to perform the function of macroeconomic stabilization, at least in part, when necessary. However, not all contingencies can be foreseen; the Commission is often compelled to interpret the margin for flexibility provided by the rules in an unavoidably discretionary manner.

A common budget, which can only be achieved by further transfers of national sovereignty and an adequate strengthening of the democratic legitimacy of supranational institutions, would make it possible to implement policies consistent with the cyclical conditions in various economies and in the euro area overall, promptly and with no doubts as to their legitimacy. The single currency needs to interact with a single fiscal policy.

To be effective, a fiscal union requires the introduction of common debt instruments and, at the same time, decisions on the treatment of pre-existing national debt with a view to a single euro-area debt. A number of practical proposals to this effect have been put forward, some of them quite recently. In my concluding remarks on this occasion four years ago, amidst very severe sovereign debt tensions, I emphasized the need to increase our common resources, including by instituting a fund to which a portion of sovereign debts could be assigned; these would eventually be redeemed, according to clearly defined rules and without transferring funds between countries, thereby giving rise to a form of fiscal union not lacking cogent rules and powers of control and intervention.

The levels of public and private debt, as well as the indicators of the former's long-term sustainability, differ markedly among euro-area countries. In Italy, for example, the ratio of private debt to GDP is lower than the EU average; that of public debt is very high, while Italy's sustainability indicators are among the area's best, thanks in part to a series of pension reforms. On average, the situation in the euro area is comparable to or better than in the other main advanced economies; the less favourable position of European firms is offset by the better situation of households.

Yet it is the euro area that is the focus of the markets' most serious concerns. The area is currently subject to exceptional strains, both economic and geopolitical. The reaction of a large part of public opinion, and in some cases of governments, has been one of fear and rejection; the European project is seen more and more as part of the problem, less and less as the solution. But it is the very magnitude and the diffuse nature of the risks we face that demand a common strategy that goes beyond emergency response. To move forward in the integration process we need to rebuild trust among countries, both at a political level and between ordinary citizens. The first step has to be to tackle weaknesses at the national level, as Italy has done in the past few years and will have to continue doing. However, the effort of individual countries must be sustained by concrete progress in the European construction.

Banks and supervision: these last, challenging years

Beginning in the second half of 2011, at the height of the sovereign debt crisis, and continuing in 2012, Italian banks had to deal with a significant deterioration in their wholesale funding; although the quality of loans in general was deteriorating, situations of severe difficulty remained limited to just a few banks. In 2013 the International Monetary Fund acknowledged the proven ability of the Italian banking system to contain the effects of the crisis and ensure adequate capitalization by resorting to the market.

With the return of the recession, widespread company failures and job losses fuelled a further rise in non-performing loans; in a vicious circle, increased credit risk led banks to tighten supply. Most of our banking system has faced the crisis with courage and transparency, but in more than a few cases the effects of the long, deep recession have been compounded by imprudent and at times fraudulent conduct by senior management.

As the crisis unfolded, international banking regulations changed rapidly, especially, as I noted earlier, those on the management of bank failures. The issue of the four banks put under resolution in November needs to be examined in this context. I will not dwell today on the events that led them into crisis, on our supervisory action and our close cooperation with the judiciary; we have described this on many occasions, in statements and notes of clarification, and most recently in my testimony before the Senate on 19 April giving a detailed account of the recent crises involving several Italian banks. Together the four banks accounted for 1 per cent of total system-wide assets. The repercussions of their collapse confirm that even when the banks involved are small, loss of public trust can spread quickly and generate persistent systemic effects.

Our intervention ensured the operational continuity of the four intermediaries. The new banks, their balance sheet assets freed of bad debts, are now strengthening their ties with their million or more customers among depositors and small and medium-sized enterprises. Recent Government measures to reimburse the holders of subordinated bonds issued in the past seek to strengthen customer trust. The sale of the four banks on the market is at an advanced stage and adheres to strict criteria of transparency, impartiality and competition; the process is scheduled to be completed during the summer. The assignee of the bad debts is preparing the data necessary for their competitive sale. This could contribute to the development of a market for non-performing loans in Italy.

Banking crises are always delicate to navigate for supervisory authorities. They are called upon to minimize the likelihood of collapses and contain the fallout. This responsibility entails a reflection on the causes of the crises, on how they can be identified more quickly and on how on- and off-site intervention can be improved. But an important point should not be forgotten: the laws and the prudential supervisory model that have gained international acceptance over the years, under the impulse of the Basel Committee, are rightly centred on entrepreneurial independence in banking. Supervisory authorities cannot systematically make banks' operating decisions for them.

Anomalies and irregularities are usually discovered or confirmed by on-site inspections; we carry out about 200 every year. Ferreting out these often cleverly concealed situations is not easy and can take time. The supervisory authority performs the difficult job of conducting inspections and investigations; it does not have the tools available to the judicial authorities (such as search and seizure). The powers and responsibilities of the administrative authorities and of the prosecution are, as is only right, kept strictly separate. The full and timely cooperation of the two is obviously essential.

Once we have identified a problem, we always aim to lay the groundwork for its resolution. When we uncover evidence of a possible crime we promptly inform the prosecutor's office. The public is not usually aware of this since, with rare exceptions, the law imposes official secrecy on the reports, information and data obtained by the Bank of Italy in the course of its supervisory activity. There is a precise and important reason for such a rule: to prevent news of isolated incidents from exacerbating temporary or solvable problems and generating destabilizing effects, with serious consequences for all.

In the last twenty years we have managed through special administration 125 crises of primarily small banks, 56 of which in the last seven years. Over half the procedures concluded with banks resuming ordinary administration. About a third of the banks involved were liquidated, and liquidation was almost always accompanied by the transfer of assets and liabilities to another bank, thereby guaranteeing the continuity of customer relations. As a result of our intervention it was possible to hold to account those responsible for the failures.

Prior to the recent regulatory changes, bank crises were resolved with no costs for depositors or bondholders thanks to the intervention of deposit guarantee funds. We have taken resolute action in the numerous problematic cases which did not go as far as special administration, calling for remedial action, obtaining the replacement of directors where necessary – even with the limited regulatory instruments available, which have only recently been revised – and imposing capital increases.

We are aware of the greater difficulties encountered nowadays in dealing with banking crises and the serious consequences that may ensue in terms of investors' trust. We constantly update our methods and procedures of preventive intervention. We are open to constructive criticism, as we are committed to being accountable for our work.

We work closely with government authorities, with the other supervisory and control authorities and the banks themselves. Examples of this cooperation are the creation of the Atlante private investment fund, which has already participated in a capital increase requested by the supervisory authorities, and the initiatives to set up voluntary banking funds for intervention in the event of a crisis.

The problems still facing Italian banks

Banks in Italy, like those in other countries, are faced today with profound changes in technology and market structure. The still weak economic situation and the uncertainty associated with regulatory changes are compounded in Italy by the large volume of non-performing loans, which squeeze profitability, and inadequate governance arrangements. Important measures have been taken of late on both fronts; banks need to act swiftly to seize all the opportunities these offer.

Net of value adjustments that banks have already made, the stock of non-performing loans comes to just under €200 billion. More than half that amount refers to situations where the borrower's difficulty is temporary. Looking at bad debts alone, the net value is less than €90 billion. This burden is considerable, but it is in large part backed by collateral whose value was carefully examined in 2014 during the comprehensive assessment of the leading euro-area banks; in addition to this collateral, there are personal guarantees. Overall, the concerns about the quality of Italian banks' assets must be taken seriously, but without overestimating the extent of the problem.

The non-performing loans are largely the legacy of the long and deep recession. We have now reached a turning point. The moderate economic recovery under way since last year is being reflected in a significant decline in the flow of new non-performing loans; in 2015 this was equal to 3.7 per cent of total loans, compared with 4.9 per cent in 2014; for the household sector, the flow is back down to pre-recession levels. The process of normalization continues.

One factor that until now has played a role in the growth of the stock of non-performing loans has been the slowness of insolvency and recovery procedures. The legislative reforms introduced last summer and those approved at the beginning of this month serve to speed them up. With the out-of-court assignment of property pledged by firms as collateral, recovery times could shrink to a matter of months from the previous estimate of more than three years, already reduced by last summer's reforms. The system-wide impact of the measures imposing the stipulation of explicit agreements will increase as they are included in new and renegotiated loan contracts with greater frequency. Shorter recovery times can increase the value of non-performing loans substantially, making it easier to dispose of them on the market.

A significant contribution could come from improving the efficiency of the courts; there are considerable geographical disparities in the length of foreclosure and bankruptcy procedures, sometimes even within the same region. The disposal of bad debts could be further facilitated by the state guarantee scheme for securitized bad debts (Gacs), which will help to raise the sale price by making the senior tranches of securitizations more attractive for investors.

The growth of the market in non-performing assets will also receive a boost from the investments of Atlante, a private fund that can concentrate on the riskiest securitization tranches. Even with relatively modest resources for the moment, Atlante can demonstrate that buying bad debts at higher prices than those now offered by specialized investors can in fact produce attractive returns. We believe the fund has the determination, independence and professionalism to meet this challenge; the more it succeeds, the more it will become possible to raise fresh resources, creating a virtuous circle.

Sale is only one of the ways of dealing with the problem of non-performing loans. Supervisory authorities and banks have a common interest, in this phase, in making the active, efficient and informed management of such loans a strategic objective. Possible improvements range from strengthening internal procedures to outsourcing to specialized operators. As part of its efforts to motivate the banks, the Bank of Italy has recently launched a new periodic survey to gather detailed information on the stock of bad debts, the related collateral and guarantees, and recovery procedures. It lays the basis for vigorous organizational intervention which, in turn, is the precondition for solving the problem, not overnight but within a reasonable timespan.

Those responsible for European supervision are aware that the reduction of non-performing exposures can only be gradual. The actual situation of the individual banks will be assessed and the most appropriate supervisory measures identified considering the context in which they operate. At the same time, within the Single Supervisory Mechanism we are striving to make our action more effective with respect to all the risks that bear on banks' balance sheets, more importantly those associated with structured financial products.

The law reforming the cooperative banks has created the conditions for resolving the problem of monitoring the activity of the directors, which in cooperatives can be less than effective or even subject to perverse incentives, and that of constraints on capital-raising in the market. In the largest of the cooperative banks, these weaknesses were particularly serious. The law provides appropriately differentiated remedies. The smallest cooperative banks are offered opportunities, which have to be fully exploited, to improve their overall quality of governance and increase their capacity to raise capital. For large cooperative banks, a sharp break was necessary.

Their transformation into joint stock companies makes it possible to solve what had become urgent problems, such as the lack of transparency of directors' decisions, the self-referentiality of several top-tier figures, and resistance to change. It must foster consolidations that make it possible to rationalize the banks' organization, increase profitability and efficiency, and strengthen capital. The law has set an appropriate period of time – ending next December – to allow the largest cooperative banks to plan their strategic choices and carry out all the necessary formalities for their corporate transformation.

This process needs to be completed swiftly: waiting until the last minute will expose the banks to uncertainty.

The reform of the mutual banks must be carried out fully and without delay; this is indispensable to strengthen the sector and bring its business model up to date, adapting to changing technologies and markets. The Bank of Italy will issue the secondary legislation without delay, in coordination with the ECB; we expect its equally timely implementation by the system. In defining group structures and the relations among the various components, it is necessary to follow strictly entrepreneurial logic, by means of a cohesion pact that gives effective powers to the parent company, and to strive for rationalization and efficiency gains. The mutual banks' associations can still play a representative role at the national and local level, without undue interference with the group's strategic planning, operational management and control functions.

Banks' costs and profitability

To fund the economy banks must be stable and well-capitalized; they must be able to generate adequate profitability. In recent years profits have been squeezed by the need to adjust the value of non-performing loans; the write-downs amounted to more than €120 billion in the four years 2012-15. With the economic recovery, the impact of this factor is diminishing, but new elements have emerged, such as low interest income, the need to reduce financial leverage, and the fall in the prices of some services due to advances in technology and increased competition. A recovery necessarily entails an increase in efficiency, a curbing of costs, and a diversification of income sources; targeted consolidations, according to sound business projects, can stimulate and abet this process.

In 2015 banks' operating costs – net of extraordinary contributions to the National Resolution Fund – remained stable. The cost-income ratio is 64 per cent, slightly above the average for European groups and below that of the main French and German banks. Nevertheless, given their specific situation, for many Italian banks it remains imperative to take steps to contain costs, including staff costs, by adapting the quality and quantity of personnel to technological and market developments. The business model, grounded in a widespread presence in local markets, is in need of further adjustment by continuing to reduce the number of branches, which last year declined to around 30,000 or 11 per cent less than in 2008.

Greater use of technology, starting with further development of digitization, would permit significant cost savings in the provision of traditional services amenable to standardization. In the list published last February by the European

Commission, our country still ranked twenty-third in Europe in the use of e-banking, although this is increasing and banks have expanded the array of products they offer through innovative channels. The pronounced disparities between banks of different size show there is room for improvement: the share of households with access to home banking is in fact nearly 60 per cent for the five largest groups, 45 per cent for small banks and barely 35 per cent for minor banks.

The savings thus obtained could be fruitfully invested in reorganizing branch networks, concentrating the physical points of contact with customers in a limited number of branches specialized in offering high value added services, such as corporate finance for businesses and asset management for households. A branch network whose design avoids overlap and increases efficiency in contacts with customers is not to the detriment of relations with households and businesses.

Another impetus for revisiting the business model is the evolution of the financial system towards a growing role for channels of financing for the economy alternative to banking. Even though non-bank intermediation remains decidedly less well-developed in Italy than in other countries, some recent initiatives – in favour of credit funds, the issuance of loans by securitization vehicles, the financing of businesses via mini-bonds and a more active role of insurance companies – are making for a more dynamic market. This process will be furthered by European measures for the capital markets union. Moving in this direction, we will soon publish for consultation regulations enabling foreign funds to make loans in Italy.

Banks can respond to the downsizing of traditional channels by increasing proceeds from the development of new services. In seizing these opportunities, the necessary safeguards to prevent conflicts of interest must be put in place. The changing external context calls not only for greater financial awareness on the part of customers, but also for even stricter controls on the correctness of banks' conduct. The Bank of Italy is actively engaged on various fronts: it has stepped up its supervisory action with regard to the transparency and proper conduct of banks, with the goal of focusing their attention on service quality and increasing customer satisfaction; it has strengthened the Banking and Financial Ombudsman; it assesses customer complaints of improper practices and assiduously calls upon banks to resolve disputes. Together with Consob and the Government, we are working on enhancing consumer protection and financial education for bank customers, including young people, in the firm belief that this is a structural overhaul that necessitates a national plan, a collective effort, and a long-term commitment.

For the banks that are in difficulty, swifter and more resolute cost containment is indispensable. The repercussions on the employees involved may be also softened by the recent expansion of eligibility for the solidarity fund for the banking industry. For minor banks the problems posed by the large stock of non-performing loans, scant diversification of sources of income and the need to adapt to technological developments may be acute. In several cases they must be dealt with by implementing farsighted consolidations that exploit potentially substantial economies of scale and scope. It is necessary to move rapidly in this direction, overcoming the outdated concept of mere local presence which has often aggravated rather than attenuated the problems of the real economy and of the banks themselves.

* * *

We are slowly, haltingly coming out of a lengthy period of crisis, not only financial and economic. The recovery is not yet on a firm footing. The consensus forecasts are that Italy will not return to pre-crisis levels of income for some time; estimates of our economy's growth potential are disappointing. We can and must do more.

Monetary policy covers the whole of the euro area; its contribution to keeping aggregate demand buoyant is crucial; it is now providing highly favourable conditions that Italy must take advantage of to introduce further structural reforms, which are necessary to relaunch business activity and create more and better job opportunities, particularly for young people. Reforms tend to bear fruit only after some time; the more comprehensive is the project and the clearer the objective, the sooner we can make an impact on confidence and expectations. Our goal must be to lead firms and the economy as a whole back onto a path of sound and steady growth in productivity; innovation and investment must benefit from a nurturing and rewarding environment.

The financial system still faces enormous challenges. Efforts to strengthen it must continue. Backed by tangible progress on the European front, creating a more open capital market that will welcome firms which today do not issue shares and bonds is an objective we cannot overlook. Financial intermediaries must become more efficient, more profitable and venture into new areas of operation and so become more stable and safe. The authorities must be pragmatic in seeking to adapt their tools to safeguard stability.

The Italian banks have clearly suffered from the crisis; as national and European supervisory authority we now have to handle delicate and difficult situations. We are doing so in an environment that has undergone profound and rapid changes, cooperating actively with all the institutions and authorities concerned.

The volume of non-performing loans is large and earning capacity is low. And yet there is widespread determination to overcome the difficulties and once again serve the economy with profit. The measures taken to deal with bad debts, now and in the future, are important; our assessment of the first steps made in this direction is positive; the work must continue with courage and farsightedness. The Bank of Italy, as well as the Government and the banks, will ensure that these measures are as effective as possible on both the technical and regulatory level.

To minimize the risk of bank crises, however, we need swift action, structural change, far-reaching organizational reform and constant monitoring of the quality of senior management. Major reform measures have been introduced in the last twelve months or so concerning the role of banking foundations and the structure of the cooperative banks and mutual banks. In some cases, pre-existing weaknesses have led to extremely adverse results. Opportunities have now arisen that must be grasped without delay. The process is not an easy one, as recent events have demonstrated.

The new European crisis resolution procedures stem from justifiable concerns about how opportunism and favouritism can weigh, including financially, on the community. The new rules must be applied responsibly and advisedly to counter this type of conduct and prevent an irreversible deterioration in a bank's balance sheet from persisting too long and worsening the effects of its collapse. Adjustments can be suggested to make the crisis resolution procedures more effective and less likely to generate instability, not to prolong irreparable situations but to resolve them in an orderly manner. Such action is part of the efforts to ensure the success of banking union, to which we are fully committed.

The European construction is proceeding by gradual and increasingly difficult stages. There has been a significant transfer of sovereignty on economic and financial matters, especially in recent years. It is, in fact, illusory to believe that we can direct the course of the economy and finance, patently global phenomena, from within the limited confines of individual European countries. This construction, however, is lopsided and incomplete; its very sustainability requires that the missing elements be incorporated.

Today progress appears more difficult. The legacy of the crisis and the anxieties generated by geopolitical tensions – the migrant emergency and civil wars in nearby countries – have roused in the sentiments of many of Europe's citizens, and at times in the governments that give voice to them, fears and prejudices once thought long buried. Distrust leads to disaccord; in the exasperated pursuit of mutual reassurance, looking only to short term gain, the necessary steps are hard to take. Moving forward on the basis of a series of compromises is becoming more difficult. European unity is achieved with the development of democratic institutions appointed to manage shared sovereignty.

During the crisis the task of safeguarding the stability of the euro area fell almost entirely to monetary policy, owing to the persistent fragility of the other elements of the institutional framework, which were only belatedly and insufficiently rectified. It is not easy to recover trust or a sense of belonging; nor is it possible to ignore the underlying reasons fuelling protest among national public opinion and criticism of political institutions, especially European ones. Well-being and security are basic needs: however, guaranteeing them by responding to global challenges in a fragmented manner and keeping threats at bay by rebuilding national barriers have little chance of success; on the contrary, they inflict inevitable and serious damage.

The concrete achievement of monetary union, banking union, capital markets union, and even the prospect of a common fiscal policy, all call for a leap in quality. The identification of shared ground on questions that are fundamental to defining our common European citizenship, such as internal security and the management of immigration, will make it less difficult to proceed with the construction of a 'genuine economic and monetary union'.

Altiero Spinelli died in Rome thirty years ago. His life was an unceasing testament to the belief that his generation, the one that had both unleashed and endured the fratricidal European wars of the twentieth century, was bound to overcome forever its divisions with the union of the democratic states of Europe. Europe counts him among its founding fathers. To reprise the words of the Ventotene Manifesto, the document Spinelli drafted over seventy years ago with his companions during internment, we still need a union that 'breaks decisively economic autarchies'; a union that starts anew from the founding values of the European project: peace, liberty, equality, and the promotion of well-being for all.